The first in an ongoing series

Impact On

Banks, Thrifts, and Their Holding Companies

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act) makes significant changes to the prudential supervision framework for the banking and thrift industries, and imposes a number of new requirements and limitations on business activities. While much attention has been paid to Dodd-Frank’s new provisions relating to systemically important firms,¹ other provisions of the Act affect all banking and thrift institutions. Those are the issues we highlight in this A Closer Look, putting specific emphasis on regulatory consolidation; capital adequacy considerations; the Volcker Rule; compensation standards; and new corporate compliance requirements for banks, thrifts, and their holding companies. While many changes are incremental in nature or will be phased in over time, collectively they will have a material influence on the financial services landscape.

¹ For a discussion of requirements for systemically important institutions, please refer to the companion piece in this series, titled “Systemic Risk, Capital Adequacy, and US Financial Reform.”
Regulatory consolidation

Through the legislative process that ultimately resulted in Dodd-Frank, various options and proposals were considered to streamline the US financial services regulatory structure. Ultimately, Dodd-Frank provides for the abolishment of the Office of Thrift Supervision (OTS), the current federal supervisor for thrifts and thrift holding companies, and the reallocation of its supervisory and rule-making responsibilities to two separate agencies: the Office of the Comptroller of the Currency (OCC) for thrifts and the Federal Reserve Board (FRB) for savings and loan holding companies (SLHCs). The transfer of responsibilities is to take place one year after the promulgation of Dodd-Frank, though provisions allow for extensions of that deadline if necessary.

As a transition matter, Dodd-Frank provides that all “orders, resolutions, determinations, agreements, and regulations, interpretative rules, other interpretations, guidelines, procedures, and advisory materials” issued by the OTS would remain in force until modified, terminated, or superseded by the OCC for thrifts and/or the FRB for SLHCs. Dodd-Frank confirmed the continued existence of the thrift charter option.

The abolishment of the OTS and transfer of its powers to the OCC and FRB will ultimately result in significant changes to the regulatory environment for the thrift industry. Both the OCC and FRB are banking regulators, so future convergence of banking and thrift prudential standards can be reasonably anticipated. Further, the FRB places significant emphasis on its holding company supervision program, which suggests that SLHCs will be subject to a higher degree of regulatory scrutiny than they were in the past.

The Collins Amendment: strengthening capital standards for holding companies

In response to the recent financial crisis, a key goal of Dodd-Frank was to promote stronger industry capital standards, particularly for the largest firms. Dodd-Frank includes statutory requirements (known as the Collins Amendment) that extend the current capital adequacy framework for insured depository institutions, including the risk-based capital framework (as detailed under Section 38 of the Federal Deposit Insurance Act) and leverage standards, to SLHCs, bank holding companies (BHCs), intermediate US holding companies owned by foreign banks, and nonbank financial companies (NFCs) that are systemically important and supervised by the FRB. For SLHCs, intermediate holding companies, and NFCs that are systemically important, the Act provides a five-year period before imposition of these new requirements. Dodd-Frank also requires that the FRB establish more stringent capital adequacy standards, subject to tailored application based on their risk profile, to BHCs with assets of $50 billion or greater and to NFCs determined to be systemically important by the Financial Services Oversight Council. Dodd-Frank further empowers the FRB to establish regulations to limit the amount of short-term debt as a proportion of capital stock and surplus (or other basis as determined by the FRB) for these institutions.

A controversial element of the Collins Amendment involves the exclusion of hybrid capital instruments from Tier 1 capital for determining holding companies’ capital adequacy. These hybrid instruments, such as trust preferred securities, have historically been a significant component of BHC Tier 1 capital, particularly for smaller institutions; however, they have not been included in Tier 1 capital for insured depository institutions. Dodd-Frank provides that the FRB, by regulation, shall reduce the reliance on hybrid capital instruments by BHCs with assets greater than $15 billion by causing hybrid capital issued prior to May 19, 2010, to be deducted from capital over a three-year period commencing January 1, 2013. Hybrid capital issued by SLHCs, intermediate BHC subsidiaries of foreign banking organizations, and systemically important NFCs would be subject to the same three-year phase-out provided for BHCs with more than $15 billion in assets, even though the capital provisions do not apply until five years after enactment. Hybrid capital instruments issued by BHCs and SLHCs with assets of $15 billion or less before May 19, 2010, would be permanently grandfathered. Any hybrid capital instruments issued subsequent to May 19, 2010, would be deducted from capital adequacy calculations.

Dodd-Frank includes several other provisions that may have a material impact for some firms. For instance, it requires the FRB to conduct annual stress tests for systemically important BHCs and NFCs using at least three scenarios of increasing adversity. The Act also requires systemically important NFCs and BHCs with assets in
excess of $50 billion to conduct semi-annual stress tests. All other financial companies that have total consolidated assets of more than $10 billion and are regulated by a primary federal financial regulatory agency must conduct annual stress tests. The foregoing semi-annual and annual stress tests must also employ three scenarios of increasing adversity, under standards to be laid down by their respective federal banking agency or the FRB. Dodd-Frank also codifies a long-standing FRB policy that BHCs must serve as a “source of strength” to their depository institution subsidiaries, and extends this requirement to SLHCs and NFCs.

Collectively, many of the requirements of Dodd-Frank’s capital adequacy provisions need to be specified through the FRB’s rulemaking processes. That being said, it is evident that Dodd-Frank will require increases in capital held by the very largest firms and potentially by other BHCs and SLHCs. Firms that currently place a reliance on hybrid capital instruments for capital adequacy purposes may be required to readjust their capital structures unless otherwise grandfathered. Further, SLHCs—hitherto exempt from consolidated capital requirements—will become subject to such standards, necessitating a re-evaluation of their capital adequacy needs.

**The Volcker Rule: prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds**

The Volcker Rule provisions of Dodd-Frank — created based on proposals by White House economic advisor and former FRB chairman Paul A. Volcker — are intended to promote the safety and soundness of insured depository institutions by limiting the scope of proprietary trading activities. They also limit the extension of the federal bank “safety net” (e.g., the benefits of federal deposit insurance and access to the FRB Discount Window) to hedge funds and private equity funds. This section of Dodd-Frank is complex as it contains numerous exceptions to the general rule as well as provisions for extending the date by which affected financial institutions must fully comply with Volcker Rule requirements.

**Proprietary trading restrictions.** The Volcker Rule amends the Bank Holding Company Act of 1956 to prohibit proprietary trading by a “banking entity,” subject to certain exceptions. A banking entity is defined as any insured depository institution, excluding those that function solely in a trust or fiduciary capacity, any BHC or SLHC or company that is deemed to be a BHC under the International Banking Act, and any affiliate or subsidiary of such an entity. While proprietary trading is generally prohibited, such trading is permissible for the following purposes:

- The purchase, sale, acquisition, or disposition of US government, agency, or government sponsored enterprise (GSE) securities
- The purchase, sale, acquisition, or disposition of securities in connection with activities related to underwriting or market-making, to the extent that any such activities are designed not to exceed the reasonable expected near-term needs of clients or counterparties
- Risk-mitigating hedging activities in connection with and related to individual and aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce risk to that entity
- The purchase, sale, acquisition, or disposition of securities on behalf of customers
- Investment in small business investment companies as defined in the Small Business Investment Act
- The purchase, sale, acquisition, or disposition of securities by a regulated insurance company for its general account, if such activities are permitted under state law and regulated by state insurance authorities
- Proprietary trading conducted solely outside of the United States by a banking entity insofar as that entity is not directly or indirectly controlled by a banking entity constituted under the laws of the United States or one or more states
- The acquisition of an equity interest or other ownership interest in a hedge fund or private equity fund by a banking entity, provided that no such interests are offered to residents of the United States and the banking entity is not controlled, directly or indirectly, by a banking entity constituted under US federal law or the laws of one or more states
• Any other activity determined by rule of the federal banking agencies, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC) that would promote and protect the safety and soundness of the banking entity and the financial stability of the United States

An otherwise permissible activity could be prohibited if, by rule, the federal banking and securities agencies found that it would involve a material conflict of interest, would expose the banking entity to high-risk assets or high-risk trading activities (as to be defined by rule), or would pose a threat to the financial stability of the United States. The federal banking and securities agencies are also directed by Dodd-Frank to review permissible activities and, as needed, impose additional capital, diversification, and other rules to govern these activities.

**Prohibitions on acquisition of equity, partnership, or other ownership interests in hedge or private equity funds.** While banking entities are prohibited from taking significant ownership stakes in hedge or private funds, they are permitted to organize and offer such funds and serve in a management role (e.g., as a general partner, managing director, managing member, or trustee of the fund) if and only if they adhere to the following restrictions:

• The banking entity provides bona fide trust, fiduciary, or investment advisory services
• The fund is offered in conjunction with such trust, fiduciary, or investment advisory services and is offered only to customers of the banking entity's services in these areas
• The banking entity retains only a de minimis investment in the hedge or private equity fund offered (defined as less than 3% of the total ownership stake in the fund one year after offering, constituting an investment that is immaterial to the banking entity, and representing in aggregate less that 3% of the Tier 1 capital of the banking entity)
• Any transactions with a hedge or private equity fund organized or offered by the banking entity become subject to the requirements of Sections 23A and 23B of the Federal Reserve Act
• The banking entity does not insure or guarantee the performance of the hedge or private equity fund
• The banking entity does not share its name with the hedge or private equity fund for marketing or other promotional purposes
• No director or employee of the banking entity retains an ownership interest in the hedge or private equity fund
• The banking entity provides disclosure to hedge or equity fund investors that all risks of loss in the fund shall be borne solely by fund investors

The FRB may permit a banking entity to offer prime brokerage services to a hedge or private equity fund that the entity has organized, sponsored, and advised if (i) the banking entity is in compliance with the restrictions outlined above with respect to that fund, (ii) the banking entity’s CEO makes a formal certification to that effect, and (iii) the FRB determines that such activity is consistent with safe and sound banking practices.

The Volcker Rule provisions of Dodd-Frank become effective 12 months after the federal banking agencies, the SEC, and the CFTC promulgate rules to enforce Dodd-Frank’s provisions or two years after enactment. Banking entities must divest impermissible ownership interests in hedge or private equity funds within two years of the effective date of this section of Dodd-Frank. The FRB may extend this divestiture period for up to three one-year terms by rule or order. The FRB may also extend the divestiture period for illiquid ownership interests for up to five years after the issuance of final rules or the effective date of this section of Dodd-Frank. Divestiture period extension(s) may apply to, or be constrained by, the investment commitment period of such illiquid funds, as applicable.

*While the Volcker Rule imposes restrictions on the ability of banks, thrifts, and their holding companies to engage in proprietary trading and to maintain relationships with sponsored or advised hedge and private equity funds, the nature and extent of those restrictions is largely dependent on the outcomes of the federal banking and securities agencies’ rule-writing process. Banking organizations should monitor the rule-writing process closely to assist in determining an appropriate course of action.*
Compensation standards

Dodd-Frank contains numerous provisions relating to compensation standards for publicly traded companies, including requirements for shareholder advisory votes on incentive compensation and so-called “golden parachutes,” along with enhanced disclosure and independence requirements for corporate compensation committees. With respect to the financial services industry and in response to perceived excesses in management compensation, Dodd-Frank requires the appropriate federal banking agencies to issue joint rules or guidelines for incentive-based compensation arrangements at supervised financial institutions with $1 billion or more in assets, in order to discourage inappropriate risk-taking.

While Dodd-Frank’s provisions relating to executive compensation will pose corporate compliance issues for publicly traded firms, recently issued interagency guidance on executive compensation for financial firms has largely “front run” these statutory requirements.
While Dodd-Frank will have significant impact on the banking and thrift industries, many implementation issues are currently unclear and are subject to federal agencies’ rule-making processes and various statutorily directed studies. PwC will continue to monitor those developments and provide you with updates, which will be available at www.pwcregulatory.com.

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